

**MINUTES
of the
SECOND MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE**

**July 3, 2007
State Capitol
Santa Fe**

The second meeting of the Investments and Pensions Oversight Committee for the 2007 interim was called to order by Senator John Arthur Smith, chair, on Tuesday, July 3, 2007, at 10:15 a.m. at the State Capitol in Santa Fe.

Present

Sen. John Arthur Smith, Chair
Sen. Joseph J. Carraro
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Sen. Mary Kay Papen
Rep. Henry Kiki Saavedra
Rep. Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent

Rep. John A. Heaton, Vice Chair
Rep. Donald E. Bratton
Sen. Phil A. Griego

Advisory Members

Rep. Andrew J. Barreras
Gary Bland, State Investment Council
Sen. Carlos R. Cisneros
Rep. Miguel P. Garcia
Robert Gish, Public Employees
Retirement Association
James Lewis, State Treasurer
Rep. Patricia A. Lundstrom
Rep. John Pena
Rep. Jane E. Powdrell-Culbert
Sen. H. Diane Snyder
Rep. Sheryl Williams Stapleton

Sen. Pete Campos
Sen. Stuart Ingle
Bob Jacksha, Educational Retirement Board
Olivia Padilla-Jackson, State Board of
Finance
Sen. Leonard Lee Rawson
Sen. Michael S. Sanchez
Rep. Eric A. Youngberg

Staff

David Abbey, Legislative Finance Committee (LFC)
Doris Faust, Legislative Council Service (LCS)
Norton Francis, LFC
Larry Matlock, LCS
Wayne Probst, LFC
Doug Williams, LCS

Guests

The guest list is in the meeting file.

Tuesday, July 3

The committee adopted the minutes of the June 14, 2007 meeting.

Retiree Health Care Authority (RHCA)

—Marie Thames, Executive Director, RHCA

—Gary Petersen, Siegal Company

Mr. Petersen began with the following glossary of terms that would be used in the presentation:

- Actuarial Present Value (APVB): Present value of all future benefit payments for current retirees and active employees taking into account assumptions about demographics, turnover, mortality, disability, retirement, health care trends and other actuarial assumptions. The Government Accounting Standards Board (GASB) does not require disclosure of this number.
- Actuarial Accrued Liability (AAL): The portion of the APVB allocated to years of employment prior to the measurement date.
- Actuarial Value of Assets (AVA): The value of assets used by the actuary in the valuation. These may be at market value or some other method used to smooth variations in market value from one valuation to the next.
- Funded Ratio: The ratio AVA/AAL.
- Unfunded Actuarial Accrued Liability (UAAL): The difference between the AAL and the AVA.
- Normal Cost (NC): The portion of the APVB allocated to the valuation year of service. Annual Required Contribution (ARC): The NC plus amortization of the UAAL (must be amortized over a period of no more than 30 years).
- Net OPEB Obligation (NOO): The amount of ARC that was not funded and that is accumulated from year to year with interest. Note: This number and its progression over time is likely to be focused on by financial analysts.

Mr. Petersen summarized the GASB situation as follows:

GASB 43 Results (in millions)

| | |
|--|------------------|
| Discount Rate | 3.50% |
| Actuarial Accrued Liability | \$5,081.2 |
| Less: Actuarial Value of Assets (per GASB) | \$0.0 |
| Unfunded Actuarial Accrued Liability | \$5,081.2 |
| Amortized over 30 Years | \$157.8 |
| Plus Normal Cost | \$308.7 |
| Annual Required Contribution (Beginning of Year) | \$466.5 |
| Annual Required Contribution (Adjusted for Payment Throughout the Year) | \$474.7 |
| Percent of Pay | 11.65% |
| Funded Ratio (per GASB) | 0.00% |

Mr. Petersen outlined several benefit plan design changes as follows:

- Savings projections for all options assume 6% growth in retirees over 02/07/2007.
- A. Increase prescription mail order copay for preferred brands from \$25.00 to \$35.00 and nonpreferred from \$45.00 to \$60.00 on all self-funded plans.
 - 1. With no change in \$12.00 generic copay.
 - 2. With increase of generic copay to \$15.00.
- B. Increase prescription mail order copay for preferred brands from \$25.00 to \$60.00 and nonpreferred from \$45.00 to \$100 on all self-funded plans.
 - 1. With no change in \$12.00 generic copay.
 - 2. With increase of generic copay to \$15.00.
- C. Gold Plan: Increase in-network coinsurance to 15% (current OOP max).
- D. Gold Plan: Modify deductible from \$100 to \$200 out-of-network, and out-of-pocket from \$500 to \$1,000 in-network and \$2,000 out-of-network.
- E. Gold Plan: Add \$100 Copay for high-tech radiology prior to coinsurance, i.e., MRI, PET and CT scan.
- F. Gold Plan: Add \$500 copay per admission to hospitalization prior to coinsurance.

The financial impact of these plan changes is summarized in the following table:

| Plan Change | 2007 per member per month | 2008 per member per month | 02/07 members x 1.06 | 2008 savings | Impact on solvency in years |
|--|---------------------------|---------------------------|----------------------|--------------|-----------------------------|
| A.1. Mail copay \$12/35/60 | \$3.30 | \$3.60 | 36,141 | \$1,561,291 | 0.75 |
| A.2. Mail copay \$15/35/60 | \$4.29 | \$4.68 | 36,141 | \$2,029,679 | 0.98 |
| B.1. Mail copay \$12/60/100 | \$11.64 | \$12.69 | 36,141 | \$5,503,551 | 2.66 |
| B.2. Mail copay \$15/60/100 | \$13.50 | \$14.72 | 36,141 | \$6,383,946 | 3.08 |
| C. 15% IN coinsurance | \$3.48 | \$3.79 | 10,148 | \$461,531 | 0.22 |
| D. \$200 OON Deductible/\$1,000 IN OOP / \$2,000 OON OOP | \$22.63 | \$24.67 | 10,148 | \$3,004,214 | 1.45 |
| E. \$100 Copay - high-tech radiology | \$1.74 | \$1.90 | 10,148 | \$231,374 | 0.11 |
| F. \$500 copay per admission - hospital | \$6.09 | \$6.64 | 10,148 | \$808,593 | 0.39 |
| | | | | | |
| Assume \$2,070,000 in annual savings = 1 additional year solvency | | | | | |
| (Measured in 2008 dollars that trend forward at health care trend rates) | | | | | |

Representative Larrañaga noted the \$5 billion unfunded liability over the next 30 years and asked about the nearer term 15-year outlook. Ms. Thames stated that RHCA will become insolvent in nine years.

Representative Varela asked about the unfunded liability if the RHCA Fund was converted to an irrevocable trust. Mr. Petersen responded that the actuarial assumptions would change and the unfunded liability would be reduced to approximately \$4 billion.

Representative Powdrell-Culbert asked about the impact of mortality on the unfunded liability. Mr. Petersen responded that mortality results in contributions remaining in the fund and reduces the unfunded liability.

Representative Larrañaga asked about the impact of return to work. Ms. Thames responded that, upon return to work, a member is required to use any employer-offered health plan, and the member no longer represents a cost to the RHCA. This includes retirees who return to state government employment. Also, it is advantageous for a return-to-work employee to use the state government benefit because the premium is less than RHCA premiums.

Representative Larrañaga asked about the advantages of the plan changes being considered by the RHCA Board. Mr. Petersen responded that the Gold Plan contains no incentive for retirees to use in-network medical providers.

Representative Lundstrom asked why the legislature did not create an irrevocable trust. Senator Smith stated that the Senate Finance Committee received conflicting legal opinions concerning the potential creation of a property right. Ms. Thames stated that the RHCA will request a written legal opinion from the Siegal Company.

Senator Leavell asked about the impact of federal Medicare reimbursements on the unfunded liability. Mr. Petersen responded that the 28% reimbursement reduces the unfunded liability by approximately \$10 million per year. Ms. Thames stated that the RHCA is exploring the possibility of becoming its own prescription drug provider (PDP), which could reduce cost and increase federal funds.

Mr. Lewis asked about the utilization rate of RHCA benefits by retirees. Mr. Petersen noted that approximately 75% of retirees use RHCA benefits.

Mr. Lewis inquired about the qualifications of certified actuaries. Mr. Petersen outlined the mathematical skills required.

Senator Snyder asked about changes in plan benefits and who would be making health care decisions. Mr. Petersen responded that, in all cases, the physician would be making the decision. Mr. Petersen noted that the only change contemplated is an increase in co-payments.

Senator Snyder asked if the RHCA has an appeals process. Ms. Thames noted that the executive director has the authority to waive fees through an existing appeals process.

Representative Powdrell-Culbert asked about the profile of illness on the unfunded liability. Mr. Petersen responded that the actuary uses an average of health care expenditures rather than individual illnesses. He noted that this approach works well with over 30,000 members.

Senator Smith asked about enrollment of municipalities in the RHCA plan. Ms. Thames responded that, as of January 2007, municipalities submitting an application are required by administrative rule to submit a statement of their accrued actuarial liability and are required to pay that amount prior to joining the plan.

Representative Varela asked about the status of Santa Fe. Ms. Thames stated that Santa Fe has paid in full.

HB 728 Working Group Update

—David Abbey, Director, LFC

—Dannette Burch, Deputy Secretary, Department of Finance and Administration

Mr. Abbey outlined the problem as follows.

The RHCA was created in 1990 to provide health care benefits to eligible retirees, their spouses and dependents of certain public participating entities.

It is now clear that, from its inception, the benefit commitment was not adequately prefunded, which has contributed to the authority's current unsustainable financial position. The following factors have compounded the impact of the funding deficiencies:

- rising costs of health care;
- increasing membership;
- over-generous service requirements, benefits packages and subsidies, insufficient premiums;
- recent mandates from the GASB;
- ineffective and inefficient internal controls and systems; and
- management lapses prior to January 2006.

Specific challenges include the following.

Financial

- Revenue shortfall:
 - membership expected to increase 7% to 8% per year;
 - claims cost expected to increase at 8% to 20%+ per year; and
 - expenditures outpacing revenue streams.
- Premium subsidy inequity:
 - premium subsidy provided to retirees, spouses and dependents applied without a clear correlation to the underlying, true cost or to the amount an individual paid into the system;
 - younger retirees receive a greater subsidy than Medicare-eligible retirees; and
 - the amount of subsidy applied by years of credible service is established in an administrative rule, but implemented by the board of directors.
- "Pay as you go":
 - system expected to operate on a "pay-as-you-go" basis. This approach is at opposition with the concept of the significant prefunding of benefits. Currently, all of the active employer/employee contributions are being spent to provide benefits to the retirees and their families.

These challenges, combined with administrative lapses and faulty actuarial assumptions in past years, have led to a reduced solvency period projection from 25 years to nine years.

Internal Systems

A recent review of the internal eligibility and billing system revealed that the internal accounting system does not work. For example, the system does not have the ability to place a value on the employer accounts receivable, only on the member accounts receivable. As a result, the collection of active employer/employee contributions, as well as employer "buy ins" has been inconsistent and without the ability to report out such inconsistencies.

In addition, an administrative rule allowed political subdivisions to buy into the system at insufficient rates prior to December 31, 2006 and, in a few cases, allowing noneligible entities to enter the system.

Total Compensation

The retiree health care system must be viewed in light of total compensation for state employees. New Mexico has a high ratio of benefits to total compensation compared to other public sector comparator markets.

Ms. Burch noted that the HB 728 Working Group is considering six areas of remediation as follows:

- subsidies, e.g., setting premiums to match benefits;
- eligibility requirements, e.g., age and service changes;
- benefit design, e.g., limit out-of-network benefits;
- revenue enhancements, e.g., increase premiums;
- administrative cost savings, e.g., agency and/or plan consolidation; and
- GASB 43, e.g., arbitrage bonds.

Representative Varela asked what the next step would be after the HB 728 Working Group develops its recommendations. Mr. Abbey responded that there may be some recommendations that can be implemented administratively by the RHCA Board and others that may have to be implemented through legislation.

Representative Varela asked if the \$3 million per year general fund appropriation from the 2007 session has been included in the current actuarial evaluation. Mr. Petersen stated that the appropriation has not yet been factored in; however, even when it is, there will be minimal reduction in the unfunded liability.

Representative Lundstrom asked staff to evaluate the cost impact of each of the options in the matrix. Ms. Thames noted that she is working with Paula Tackett to develop a request for proposals for the services of an actuary.

Senator Smith suggested that it will be important for the legislature to deal with the unfunded liability in a comprehensive manner, not in a piecemeal fashion.

Representative Trujillo indicated that the core problem is the rising cost of health care and that the ultimate solution is a single-payer system.

Workforce Demographics

—Mark Lautman, Mesa del Sol

Mr. Lautman describes the crisis in the emerging workforce as follows.

Economic development occurs when the economic base grows faster than the population. The economic base is made of jobs where the products and services being produced are sold outside the economy—bringing the new money into the economy every day. If the economic base of a community grows slower than its population, each year local government, public schools, business enterprises and households will have to serve more people with less revenue.

In most communities, the population will continue to grow because people are living so much longer. However, falling birth rates and lower educational attainment mean that beginning next year, for the first time in human history, new generations coming into the workforce will be smaller in number and less educated than the generations ahead of them. For the next 20 years, as the boomers retire, the workforce will steadily shrink in proportion to the population, making economic base growth increasingly difficult and eventually impossible in most places. Few if any community leaders in New Mexico understand the nature and scale of this demographic reality and the imminent economic, social and environmental consequences.

A new hierarchy of location factors:

- The war for talent — workforce crisis; after 2008, boomers retire faster than new workers can replace them;
- inflation — all major cost categories; labor, tax burden, energy, capital, strategic materials, insurance, real estate;
- increasing importance of security; natural disasters, terrorism, intellectual property and crime.
- accelerating technological innovation; staying on the cutting edge and ahead of competitors.

Signs that the metro labor market is beginning to tighten:

- falling unemployment rate: 4.9% to 3.5% (2005 to 2006);
- rising labor participation at 64%;
- reduced elasticity between supply and demand; and
- respondents confirm that staff recruiting is becoming more difficult (2006 WDG Labor Study).

Suggested initiatives:

- pioneer the development of a supply/demand forecast and gap analysis model for local communities. Fund a state-of-the-art labor market benchmark and survey program with a resident labor expert in each local market;
- choose specific economic base job targets for each community. Elevate state and local economic development programs. Set numerical goals for local talent needed for those career paths; and
- realign discretionary resources at New Mexico universities, community colleges and public school districts to fill predicted gaps in the high-value job targets. Promote strategic careers to local P-20 students, mid career change candidates and the gradually retiring worker. Adopt work keys as a statewide standard for education and workforce readiness.

Barriers to action:

- ignorance of the economic consequences of a labor-constrained economy;
- a lack of honest, relevant predictive data;
- educators and employers are polarized and estranged;
- there is no common nomenclature, methodology, standard or data for determining both educational attainment and workforce readiness;
- no common measurable mission;
- leaders too close to retirement to risk major change; and
- eventually, resources to solve the problem will begin to dry up.

In-Depth Examination of Hedge Funds

- Gary Bland, State Investment Council
- Robert Gish, Public Employees Retirement Association
- Steve Neel, Educational Retirement Board

Hedge funds feature the following characteristics:

- private investment partnership run by professional investment managers;
- invest in a variety of securities;
- can use various investment strategies;
- do not necessarily have to "hedge"; some use leverage and derivatives while others use little or none;
- wide variation of risk profile from fund to fund;
- LPs are investors, GP runs the fund;
- managers incentivized by share of profits;
- \$1 trillion industry, 20% growth; estimated 8,300+ active hedge funds;
- highly specialized, requiring significant expertise;
- historic returns: the greater the equities, the less the equity risk;
- performance often not specifically correlated to equities and bond markets; and
- favored by investors who have experienced major stock market corrections.

The State Investment Council strategy includes:

- fund of hedge funds allocation mitigates risk through diversification;
- 14 managers with 16 fund of hedge funds;
- exposure to 400+ individual/single strategy hedge funds;
- additional layer of fees;
- market value \$1.45 billion (9% SIC assets); and
- target returns of Libor + 200 bps.

Definitions of different hedge fund strategies:

- equity hedge strategies are stock selection funds that contain long and short equity securities with varying degrees of exposure and leverage;
- Equity long/short; funds with primarily long undervalued equities that also use short selling opportunistically but are typically net long;
- long-biased equity funds: funds containing long undervalued equities; short selling used sparingly; virtually always net long; and
- short-biased equity funds: funds containing long and short equities with the ability to be net short;
- relative value strategies:
 - seek to isolate alpha from mispricing of related financial instruments and target a beta of zero to all markets;
 - typically use quantitative and qualitative analysis to identify securities or spreads between securities that deviate from their fair value and/or historical norms; and
 - many arbitrage strategies fall into the relative value category;
- event-driven strategies:
 - focus on corporate events such as restructurings, takeovers, mergers, liquidations, bankruptcies or other special situations;
 - attempt to profit from security price changes responding to the occurrence or nonoccurrence of an extraordinary event; and
- global macro strategies:
 - also referred to as directional traders, invest opportunistically in long and short financial or nonfinancial assets in global markets; and
 - attempt to capitalize on macroeconomic factors and events, ranging from currency movements to foreign equity markets and interest rates.

Hedge fund strategy risk (in declining order):

- global macro hedge funds;
- long/short equity hedge funds;
- event driven funds; and
- relative value I arbitrage hedge funds.

fundamental hedge fund criteria risk:

- operational and management risk;

- business risk;
- strategy risk (market and nonmarket related factors); and
- liquidity risk.

Mr. Bland invited the committee members to visit the State Investment Council offices.

Committee Discussion of Agenda Items for the August 14, 2007 Meeting

- Single-Payer Health Care
- In Depth Examination of Private Equity Investing
- Small Business Investment Corporation.

Other Business

There was no other business brought before the committee.

The committee adjourned at 4:30 p.m.